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In the Supreme Court of the United States

OCTOBER TERM, 1994

CITIZENS BANK OF MARYLAND, PETITIONER

v.

DAVID STRUMPF

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING PETITIONER

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QUESTION PRESENTED

Whether the creditor of a debtor in bankruptcy may withhold payment of a debt it owes to the debtor while the creditor seeks relief from the automatic stay to exercise its setoff rights.

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INTEREST OF THE UNITED STATES

This case concerns whether, during the period that the creditor in a bankruptcy case is seeking relief from the automatic stay to exercise its setoff rights, the creditor may withhold payment of a debt owed to the debtor. This issue is of substantial importance to the United States, whose agencies and instrumentalities are often creditors under federal programs involving loans, loan guarantees, contracts, assistance and benefit payments and tax collection activities. Indeed, two of the decisions upon which the court of appeals relied in the present case involved holdings that the United States violated the automatic stay by withholding a refund of overpaid taxes for one tax

year even though the debtor had a larger outstanding tax liability for a different year. Pet. App. 9, 10, citing *United States* v. *Reynolds*, 764 F.2d 1004 (4th Cir. 1985); *United States* v. *Norton*, 717 F.2d 767 (3d Cir. 1983). A third decision relied on by the court of appeals involved efforts of the Small Business Administration to offset its loan claim against crop payments due the debtor from the Department of Agriculture. Pet. App. 7, citing *Small Business Administration* v. *Rinehart*, 887 F.2d 165 (8th Cir. 1989).

The lower courts have reached a variety of conflicting results in addressing this recurring issue. As a result, federal agencies face disparate treatment of identical claims arising under national programs. The United States therefore has a substantial interest in the resolution of this recurring conflict.

STATUTORY PROVISIONS INVOLVED

The relevant provisions of the Bankruptcy Code are reprinted in the appendix to this brief.

STATEMENT

1. Petitioner is a bank conducting business in the State of Maryland. In 1989, petitioner loaned respondent approximately $5000. That loan was in default before respondent filed a petition for relief in bankruptcy under Chapter 13 in January 1991 (Pet. App. 3). Under Section 362 of the Bankruptcy Code, the filing of the petition in bankruptcy gave rise to an "automatic stay" of various types of activity by respondent's creditors. In particular, the filing stayed "the setoff of any debt owing to the debtor

that arose before the commencement of the [bankruptcy] case." 11 U.S.C. 362(a)(7).

In October 1991, the bank moved for relief from the automatic stay in order to set off approximately $3200 then in respondent's checking account against the remaining balance that respondent owed on the loan. While the motion for relief from the stay was pending, the bank placed an "administrative hold" on the balance of approximately $3500 in respondent's checking account. During the period of the hold, petitioner temporarily refused to pay withdrawals that respondent sought to make from the account. Respondent reacted to the bank's "administrative hold" by filing a motion in bankruptcy court seeking to have the bank held in contempt of the automatic stay (Pet. App. 4).

The bankruptcy court ruled on debtor's contempt motion before addressing the bank's prior motion for relief from the automatic stay. The court concluded that the bank's "administrative hold" on respondent's account represented a "setoff" in violation of the automatic stay and, as a sanction for violation of the stay, ordered the bank to pay actual and punitive damages and attorneys' fees to respondent (Pet. App. 34-36). At that time, the court reserved its ruling on the bank's motion for relief from the stay.

Nineteen days later, the bankruptcy court granted the bank's motion for relief from the stay and authorized the bank to set off respondent's remaining account balance against the unpaid loan. By that time, however, there was nothing left to set off because respondent had withdrawn all of his funds from the bank (Pet. App. 4-5).

2. The district court reversed the judgment holding the bank in violation of the automatic stay. The

court concluded that the bank's temporary freeze of respondent's account during the period that the bank sought relief from the automatic stay was not a violation of the statute (Pet. App. 18-33).

3. The court of appeals reversed and reinstated the bankruptcy court judgment (Pet. App. 1-17). The court held that a creditor's administrative freeze of amounts subject to setoff is "tantamount" (*id.* at 9) to the exercise of the right of setoff and therefore violates 11 U.S.C. 362(a)(7). The court reasoned that its holding was compelled by "the clear and unambiguous language" of the statute, which prohibits any "setoff" during the automatic stay (Pet. App. 13-14). The court further stated that the bank's actions in freezing a debtor's accounts could substantially diminish the debtor's chances for successful rehabilitation (*id.* at 14-15). Concluding that the automatic stay had been violated by the bank, the court ordered reinstatement of the award of actual and punitive damages and attorneys' fees to respondent (*id.* at 15-16).

SUMMARY OF ARGUMENT

Section 553 of the Bankruptcy Code recognizes the defense of setoff in bankruptcy cases and Section 542(b) of the Code provides that a creditor is not required to "pay" a claim of the estate to the extent that such a claim "may be offset" (11 U.S.C. 542(b)). A creditor, such as petitioner, is not acting in violation of the automatic stay by temporarily declining to pay the debtor funds that the Bankruptcy Code expressly provides need not be paid at all.

The automatic stay of a "setoff" under Section 362(a)(7) of the Bankruptcy Code does not apply

to the creditor's temporary maintenance of the status quo while application is made to the court for a judicial determination whether a "setoff" *may* properly be made. The term "setoff" in the stay provision of Section 362(a)(7) was necessarily employed by Congress in a manner conformable with ordinary usage—to mean the formal exercise of a right of setoff through an overt act that purports to extinguish, pro tanto, the opposing claim. The completed "setoff" to which Section 362(a)(7) refers necessarily involves far more than the creditor's temporary refusal to pay a claim and the creditor's submission of that claim for adjudication under the procedures specifically provided for this purpose by Sections 362(d) and 542(b) of the Bankruptcy Code.

ARGUMENT

THE REFUSAL OF A CREDITOR TO PAY A DEBT OWED TO THE BANKRUPTCY ESTATE IS NOT A "SETOFF" THAT VIOLATES THE AUTOMATIC STAY OF SECTION 362(a)(7) OF THE BANKRUPTCY CODE

Section 362(a)(7) of the Bankruptcy Code provides an automatic stay of "the setoff" of any prepetition debt of the debtor by any creditor. 11 U.S.C. 362(a)(7). The court of appeals erred in this case in concluding that a "setoff" occurs when a creditor maintains the status quo by not paying a claim of the debtor in order to assert a defense to that claim. Sections 542(b) and 553 of the Bankruptcy Code expressly protect a creditor from the obligation to pay amounts owed to the debtor to the extent that the creditor possesses a right of setoff. A creditor, such as petitioner, is not acting in violation of the automatic stay by temporarily declining to pay the debtor

funds that the Bankruptcy Code expressly provides need *not* be paid.

1. a. As this Court stated in *Bank of Marin* v. *England*, 385 U.S. 99 (1966), the relationship of a bank and its depositor "is that of debtor and creditor" and is "founded upon contract" (*id.* at 101). A bankruptcy estate that seeks to enforce such a contractual relationship "is subject to all claims and defenses which might have been asserted against the bankrupt but for the filing of the petition." *Ibid.* One of the defenses that a bank or other creditor may assert to a claim of the bankruptcy estate is the defense of setoff. 11 U.S.C. 553(a).

It is not a violation of the automatic stay for an entity to refuse to pay a disputed debt that the bankruptcy estate asserts is owed to it.[1] Neither the Bankruptcy Code in general nor the automatic stay provisions in particular require entities against whom the bankruptcy estate asserts a claim simply to succumb to the estate's claims. The automatic stay bars various affirmative actions by the creditors of the estate

[1] The automatic stay lists several types of actions that, upon the filing of the bankruptcy case, creditors are restrained from taking. The stay restrains "all entities" from (i) commencing or continuing judicial or administrative proceedings against the debtor, (ii) enforcing judgments against the debtor, (iii) obtaining possession of, or exercising control over, property of the debtor's estate, (iv) taking action to create or enforce a lien in property of the debtor's estate, (v) taking action to create or enforce a lien in the debtor's property to secure a claim that arose before the bankruptcy case was commenced, (vi) taking action to collect a claim against the debtor, (vii) setting off any debt owing to the debtor that arose before the commencement of the case against any claim of the debtor and (viii) commencing or continuing a proceeding concerning the debtor in the United States Tax Court. 11 U.S.C. 362(a)(1)-(8).

(see note 1, *supra*), but it does not require entities against whom the estate has asserted a claim to waive all defenses that they may have to the claim and immediately pay it. As the court of appeals stated in *United States* v. *Inslaw, Inc.*, 932 F.2d 1467, 1473 (D.C. Cir. 1991), cert. denied, 502 U.S. 1048 (1992),[2]

> [t]he object of the automatic stay provision is * * * to make sure that creditors do not destroy the bankrupt estate in their scramble for relief. * * * Fulfillment of that purpose cannot require that every party who acts in resistance to the debtor's view of its rights violates [the automatic stay].

The refusal of petitioner to pay the debt claimed by the bankruptcy estate in this case, and its decision to seek an adjudication of its claimed defense of "setoff," do not violate the automatic stay.

When, as occurred in this case, the bankruptcy estate believes that an entity has improperly refused to pay a debt owed to the estate, the estate is to apply to the bankruptcy court for a "turnover" order under Section 542 of the Bankruptcy Code. Under Section 542, when "an entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order" has refused to pay that debt to the estate, the bankruptcy court may

[2] In *Inslaw*, the court rejected the assertion of the bankruptcy estate that a failure of an entity to agree with the debtor's assertion of its rights in particular property represents an "exercise [of] control over property of the estate" (11 U.S.C. 362(a)(3)) within the meaning of the automatic stay provision. See 932 F.2d at 1473.

order that entity (11 U.S.C. 542(b) (emphasis added))

> [to] pay such debt to, or on the order of, the trustee, *except to the extent that such debt may be offset under section 553 of this title against a claim against the debtor.*

The "turnover" provision thus expressly incorporates the defense of setoff under Section 553. Section 553, in turn, provides that every creditor has the right "to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the [bankruptcy] case * * * against a claim of such creditor against the debtor that arose before the commencement of the case." 11 U.S.C. 553(a).

Under these provisions, when petitioner declined to pay the debt claimed by the estate—a debt represented by the bank account balance—the estate's remedy was to apply for a "turnover" order under Section 542.[3] In such "turnover" proceedings, petitioner would have been entitled to assert its defense of setoff under Section 553 and the bankruptcy court would have been required to recognize that defense under Section 542(b).

[3] If the claim that the bankruptcy estate asserts is disputed as to either its validity or its amount, adjudication of that claim would not fall within the core jurisdiction of the bankruptcy court. See, *e.g.*, *United States* v. *Inslaw, Inc.*, 932 F.2d at 1472 ("the debtor cannot use the turnover provisions to liquidate contract disputes or otherwise demand assets whose title is in dispute"); *In re Charter Co.*, 913 F.2d 1575, 1579 (11th Cir. 1990). As the court stated in *Inslaw*, "Congress may not vest in a non-Article III (bankruptcy) court the power to adjudicate a traditional contract action where the defendant is before the court 'only because the plaintiff has previously filed a petition for reorganization in that court.'" 932 F.2d at 1472, quoting *Northern Pipeline Construction Co.* v. *Marathon Pipe Line Co.*, 458 U.S. 50, 90 (1982) (Rehnquist, J., concurring in the judgment). In this case, the claim of the bankruptcy estate was not disputed and the claim of setoff was recognized to be valid by the bankruptcy court (Pet. App. 4). In this context, the "turnover" order procedure of Section 542(b) would have been applicable and should have resulted in an order that petitioner "turn over" only the portion of the account, if any, that exceeded the amount of the creditor's setoff rights against the estate.

b. The Bankruptcy Code recognizes two specific restrictions on the statutory right of setoff under Section 553: (i) the creditor may be required in a "turnover" proceeding, notwithstanding its right of setoff, to pay the amount of the debt claimed by the estate if the estate provides "adequate protection" for the creditor's setoff right through some other means (11 U.S.C. 553(a), incorporating 11 U.S.C. 363(e));[4] and (ii) the creditor may not, indepen-

[4] The bankruptcy estate may demand payment of a matured debt that is subject to a creditor's right of setoff in order to "use" the proceeds of the debt to operate the business. *In re Edgins*, 36 B.R. 480, 483 (Bankr. 9th Cir. 1984). Since the proceeds of that debt are security for the creditor's claim (11 U.S.C. 506(a)) and are considered "cash collateral" (11 U.S.C. 363(a)), the creditor may demand "adequate protection" of its interest as a condition of payment (11 U.S.C. 363(e)). See 2 *Collier on Bankruptcy* ¶ 363.02, at 363-16 (15th ed. 1995). See also *United States* v. *Whiting Pools, Inc.*, 462 U.S. 198, 202-204 (1983). The creditor may be forced to pay the debt and forgo its setoff rights only if the trustee or debtor can furnish an alternative "adequate protection" for the setoff right. 11 U.S.C. 363(e). If the estate cannot provide adequate protection for the setoff right, the court cannot force payment to the estate. See *ibid.*; *In re Lough*, 163 B.R. 586, 588 (Bankr. D. Idaho 1994).

dently of these Bankruptcy Code procedures, set off its claim against the debtor's claim without obtaining an order from the court lifting the automatic stay against such a "setoff" (11 U.S.C. 553(a), incorporating 11 U.S.C. 362(a)(7)). Subject only to those two restrictions, the creditor's right of setoff is fully preserved in bankruptcy. *In re Corland Corp.*, 967 F.2d 1069, 1076 (5th Cir. 1992); *In re Patterson*, 967 F.2d 505, 508 (11th Cir. 1992); H.R. Rep. No. 595, 95th Cong., 1st Sess. 377 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 91 (1978).

In particular, Section 542(b) specifies that a creditor who owes a debt to the debtor is not required to "pay" that debt to the extent that the creditor's claim may be set off against it. 11 U.S.C. 542(b).[5] A creditor such as petitioner cannot logically be said to be acting in contempt of the automatic stay when it temporarily declines to pay the debtor funds that Section 542(b) of the Bankruptcy Code expressly provides need not be paid at all.

2. The court of appeals nonetheless concluded that even a temporary refusal to pay the estate's claim

[5] Section 506(a) of the Code provides further protection for the right of setoff by specifying that a creditor's claim of "setoff" against the debtor "is a secured claim." 11 U.S.C. 506(a). As a "secured claim," the right of setoff is not subject to discharge merely to enhance the debtor's opportunity for rehabilitation. See *Dewsnup* v. *Timm*, 502 U.S. 410, 418 (1992); *Johnson* v. *Home State Bank*, 501 U.S. 78, 84 (1991). "[W]hile reorganization of the debtor is an important policy goal, this goal cannot be pursued by exterminating a secured creditor's property interest. 'Reorganization is not a Holy Grail to be pursued at any length.'" *In re Rash*, 31 F.3d 325, 330 (5th Cir. 1994). See also *In re Simmons*, 765 F.2d 547 (5th Cir. 1985).

is "tantamount" to a "setoff" and is therefore barred by the automatic stay of Section 362(a)(7) (Pet. App. 9, 13-14). That conclusion would deprive the provisions of the Code that protect the creditor's defense of "setoff" of all plausible meaning.

Under the reasoning applied by the court of appeals in this case, an entity that owes a debt to the estate may not protect its right of setoff by simply refusing to pay the estate's claim and submitting its rights to adjudication in an orderly fashion. Instead, under the threat of statutory sanctions (11 U.S.C. 362(h)), the creditor must immediately pay funds demanded by the debtor and thereby relinquish its right of setoff (Pet. App. 7) ("the debtor may defeat the creditor's right of setoff by removing all funds in the creditor's possession before the creditor can obtain relief from the stay"). The facts of this case reveal that this concern is not merely theoretical: between (i) the time that the bankruptcy court entered its order finding the bank in contempt for refusing to pay the withdrawals requested by the estate and (ii) the court's subsequent order finding the bank to be entitled to set off its claim against that account, the debtor withdrew the entire account balance (Pet. App. 4-5).

The court's conclusion that the creditor must bow to the debtor's demand for payment eviscerates the provisions of the Code that purport to protect the defense of "setoff" and that specify that a creditor is *not* required to "pay" a claim subject to setoff. 11 U.S.C. 542(b). The decision of the court of appeals in this case thus fails to honor this Court's admonition that the meaning of a statute should be discerned from a reading "of the whole statute, not

of isolated sentences." *Beecham* v. *United States*, 114 S. Ct. 1669, 1671 (1994); see *United Savings Ass'n of Texas* v. *Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365, 371 (1988) (interpretation of Bankruptcy Code "is a holistic endeavor"). In particular, the court of appeals erred by disregarding the "elementary canon of construction that a statute should be interpreted so as not to render one part inoperative." *Department of Revenue of Oregon* v. *ACF Industries, Inc.*, 114 S. Ct. 843, 848 (1994), quoting *Mountain States Telephone & Telegraph Co.* v. *Pueblo of Santa Ana*, 472 U.S. 237, 249 (1985).

The decision of the court of appeals would convert the provisions of the automatic stay from a shield—that protects the estate against certain affirmative acts of the creditors of the estate—into a sword—that requires other parties to pay claims of the estate without delay and without opportunity for adjudication of the defenses they may have to the estate's claim. It is ironic that, under the court's reasoning, (i) an entity that possesses a right of setoff (a right explicitly recognized in the Bankruptcy Code itself) may be found to violate the automatic stay by refusing immediately to pay a claim of the bankruptcy estate but (ii) an entity that refuses to pay a claim of the estate based upon any *other* defense to that claim could *not* be found to have violated the stay. See *United States* v. *Inslaw, Inc.*, 932 F.2d at 1473.

The automatic stay of a "setoff" under Section 362(a)(7) of the Bankruptcy Code is not designed to defeat the ultimate right of setoff. Instead, its purpose is to ensure a provisional state of equilibrium. It stays formal implementation of a setoff pending an "orderly examination of the debtor's and creditor's rights." *In re Corland Corp.*, 967 F.2d at 1076. A creditor may initiate such an "orderly examination" by asking the court for relief from the stay. See 11 U.S.C. 362(d).[6] The bankruptcy estate also may initiate an examination of the creditor's setoff rights by applying for an order requiring the "turnover" of the disputed funds under Section 542(b).

If it is determined in such proceedings that the creditor has a valid right of setoff, the creditor is not required to pay the debt to the estate to the extent of the setoff. 11 U.S.C. 542(b). Only to the extent that the creditor's debt to the debtor exceeds the creditor's setoff rights against the debtor is the creditor required to "pay such debt to, or on the order of, the trustee" (*ibid.*).[7]

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[6] A creditor who violates the stay by setting off the mutual debts without first obtaining relief from the stay may be liable for damages and attorneys' fees to any individual injured by the violation. 11 U.S.C. 362(h). Under recent amendments to the Bankruptcy Code, the United States may also be liable for damages for a violation of the automatic stay. 11 U.S.C. 106(a), as amended by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 113, 108 Stat. 4117.

[7] When the creditor's claim may be offset against a larger debt to the debtor, the claim is oversecured. See 11 U.S.C. 506(a). In calculating the creditor's claim, the creditor is entitled to add post-petition "interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose." 11 U.S.C. 506(b); see *Rake* v. *Wade*, 113 S. Ct. 2187, 2191-2192 (1993); *United States* v. *Ron Pair Enterprises, Inc.*, 489 U.S. 235 (1989). The entire amount of the principal, interest, fees and other

3. In concluding that a creditor violates the automatic stay against a "setoff" by temporarily declining the debtor's request for payment, the court of appeals gave little heed to these carefully designed, interlocking statutory provisions. Instead, the court relied (Pet. App. 9-10) on its earlier decision in *United States* v. *Reynolds*, 764 F.2d 1004 (4th Cir. 1985), which in turn had relied on the reasoning of the Third Circuit in *United States* v. *Norton*, 717 F.2d 767 (1983). In *Norton*, which involved the government's temporary refusal to pay a refund of a tax overpayment for one year when a larger federal tax deficiency existed for a different year, the Third Circuit noted that the Bankruptcy Code neither defines the term "setoff" nor explains when a "setoff" occurs for purposes of the automatic stay. 717 F.2d at 772. The court concluded that nonbankruptcy law should govern and looked to Pennsylvania law—rather than to federal internal revenue law—to determine when a "setoff" of federal tax liabilities occurs. *Ibid.* Purporting to apply Pennsylvania law, the court stated in *Norton* that "retention of a debtor's funds by a creditor provides sufficient evidence of an intent to setoff" the mutual debts. *Ibid.*, citing *Pittsburgh National Bank* v. *United States*, 657 F.2d 36 (3d Cir. 1981).[8] Invoking the analysis

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charges may then be set off against the claim of the estate. *In re Rozel Industries, Inc.*, 120 B.R. 944, 953 (Bankr. N.D. Ill. 1990).

[8] Pennsylvania applies a rule of "automatic setoff," under which a setoff is said to occur as a matter of law at the moment that the creditor's claim matures. See *Pittsburgh National Bank* v. *United States*, 657 F.2d 36, 38 (3d Cir. 1981). Even if Pennsylvania law were the appropriate law governing the setoff of federal tax overpayments in bankruptcy (which we dispute), the Third Circuit's rationale in *Norton* would be incorrect. Under the "automatic setoff" doctrine of Pennsylvania, it is the maturation of a debt that, by operation of law, causes the debt "automatically" to be set off. See 657 F.2d at 38. If that reasoning were applied to a case involving taxes, a setoff could be said to occur "automatically" the instant that a tax overpayment was received. If the overpayment were received before bankruptcy, the setoff would be a *fait accompli* before the automatic stay ever arose and there would have been no stay violation. If, on the other hand, the overpayment were received after the bankruptcy petition was filed, the automatic stay would intervene to prevent the setoff from occurring "automatically" under state law. The state automatic setoff would be stayed by the federal automatic stay. No violation of the stay against setoffs could occur, at least not by operation of Pennsylvania's automatic setoff doctrine, upon which the Third Circuit purported to rely in *Norton*.

of *Norton* in *Reynolds*, the Fourth Circuit stated that it could not find any state or federal law as to when a "setoff" occurs with respect to tax overpayments. The court nonetheless elected to apply what it regarded as the "broader rationale" of *Norton* (764 F.2d at 1007, quoting 717 F.2d at 773):

> If a bank could freeze the debtor's accounts upon the filing of a petition in bankruptcy, the debtor's chances for successful rehabilitation would be substantially diminished.

There are two significant defects in the reasoning applied by the Fourth Circuit in *Reynolds* and in the present case.

(i) If, as the court assumes, the term "setoff" in the Bankruptcy Code is to be defined by resort to non-Code law, the general rule is that a setoff requires (i) a decision to effectuate a setoff, (ii) an

overt act accomplishing the setoff and (iii) a record of the setoff. See, *e.g.*, *Horton Dairy, Inc.* v. *United States*, 986 F.2d 286, 291 (8th Cir. 1993); *United States* v. *Bell Credit Union*, 860 F.2d 365, 369 (10th Cir. 1988); *United States* v. *Central Bank of Denver*, 843 F.2d 1300, 1309-1310 (10th Cir. 1988); *In re Saugus General Hospital, Inc.*, 698 F.2d 42, 47 (1st Cir. 1983); *Citizens & Peoples National Bank of Pensacola* v. *United States*, 570 F.2d 1279, 1283-1284 (5th Cir. 1978); *United States* v. *Citizens & Southern National Bank*, 538 F.2d 1101, 1107 (5th Cir. 1976), cert. denied, 430 U.S. 945 (1977); *Baker* v. *National City Bank of Cleveland*, 511 F.2d 1016, 1018 (6th Cir. 1975); *Michigan Carpenters' Council Pension Fund* v. *Smith & Andrews Construction Co.*, 681 F. Supp. 1252, 1254 (E.D. Mich. 1988); *Baltimore & Associates, Inc.* v. *Municipal Escrow & Title Co.*, 625 F. Supp. 1271, 1272-1273 (D.D.C. 1985); *In re Archer*, 34 B.R. 28, 29 (Bankr. N.D. Tex. 1983); *Normand Josef Enterprises, Inc.* v. *Connecticut National Bank*, 646 A.2d 1289, 1299 (Conn. 1994); *Ferguson Enterprises, Inc.* v. *Main Supply, Inc.*, 868 S.W.2d 98, 100 (Ct. App. 1993), review denied, No. 92-CA-0884-MR (Ky. Feb. 16, 1994); *United Seeds, Inc.* v. *Eagle Green Corp.*, 389 N.W.2d 571, 574 (Neb. 1986); *Hill* v. *Mercantile First National Bank of Doniphan*, 693 S.W.2d 285, 291-292 (Mo. Ct. App. 1985); *Aspen Industries, Inc.* v. *Marine Midland Bank*, 426 N.Y.S.2d 620, 622 (App. Div. 1980), rev'd on other grounds, 439 N.Y.S.2d 316 (1981). But see note 8, *supra*. See also Paul S. Groschadl, *"Freezing" the Debtor's Bank Account: A Violation of the Automatic Stay?*, 57 Am. Bankr. L.J. 75, 76 (1983). That general rule—rather than the exceptional Pennsylvania rule relied on in *Norton*—appears applicable in Maryland, where the dispute in the present case

arose. See *Barrier* v. *Marine Midland Trust Co.*, 284 A.2d 418, 424 (Md. 1971).[9]

(ii) More fundamentally, the court's suggestion that nonbankruptcy law should determine whether a "setoff" has occurred for purposes of Section 362 (a)(7) of the Bankruptcy Code cannot be reconciled with the other applicable provisions of that Code.[10]

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[9] Federal statutes governing the government's setoff rights similarly contemplate the taking of affirmative steps to execute a setoff. See 26 U.S.C. 6402(a) ("In the case of any overpayment, the Secretary * * * may credit the amount of such overpayment * * * against any liability in respect of an internal revenue tax on the part of the person who made the overpayment and shall * * * refund any balance to such person."); 31 U.S.C. 3716(a) ("The head of the agency may collect by administrative offset."); 31 U.S.C. 3728 ("The Comptroller General shall withhold paying that part of a judgment against the United States Government presented to the Comptroller General that is equal to a debt the plaintiff owes the Government [and] * * * shall * * * discharge the debt if the plaintiff agrees to the setoff * * * or * * * have a civil action brought [to establish the Government's claim].").

[10] Although a creditor's right of setoff is conferred by nonbankruptcy law, bankruptcy law governs the manner of its enforcement in bankruptcy cases. See *Studley* v. *Boylston National Bank*, 229 U.S. 523, 528 (1913). In fashioning a rule concerning how a setoff is to be executed in bankruptcy cases, courts should avoid state and other nonbankruptcy law that "would frustrate specific objectives of the federal programs" (*Kamen* v. *Kemper Financial Services, Inc.*, 500 U.S. 90, 98 (1991), quoting *United States* v. *Kimbell Foods, Inc.*, 440 U.S. 715, 728 (1979)). See *United States* v. *Little Lake Misere Land Co.*, 412 U.S. 580, 596 (1973). When the language of the bankruptcy statute indicates that a uniform federal rule is intended to govern enforcement of rights that arise under nonbankruptcy substantive law, this Court has not hesitated to adopt a uniform federal rule. See *Chicago Board of Trade*

Under Section 542(b), a creditor in bankruptcy is *not* required to "pay" a claim to which the defense of setoff applies. 11 U.S.C. 542(b). Congress could not have intended the temporary refusal to pay such a claim—and the application for a judicial determination of whether a "setoff" *may* be made—to itself represent a "setoff" in violation of the automatic stay. Instead, the term "setoff" in the stay provision of Section 362(a)(7) was necessarily employed by Congress in a manner conformable with ordinary usage—to mean the formal exercise of a right of setoff through an overt act that purports to extinguish, pro tanto, the opposing claim.[11] The completed "setoff" to which Section 362(a)(7) refers necessarily involves far more than the temporary refusal to pay a claim.

The construction of the term "setoff" adopted by the court of appeals in this case—that a creditor's

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v. *Johnson*, 264 U.S. 1, 10 (1924) (a federal definition of the term "property" is appropriate "when the language of Congress indicates a policy requiring a broader construction of the [term] than the state decisions would give it").

[11] As this Court stated in an analogous context under the bankruptcy practice that preceded enactment of the Bankruptcy Code, a "setoff" in a bankruptcy case "is [not] automatically made between parties holding mutual credits" and "is not self-executing" (*Cumberland Glass Manufacturing Co.* v. *DeWitt & Co.*, 237 U.S. 447, 457 (1915)). The administrative freeze at issue in this case is nothing more than a refusal to pay communicated to the bank's various branches and automated teller machines. The fact that the freeze must be communicated internally and effected on an institution-wide basis does not make the bank's refusal to pay any more objectionable under the automatic stay. It is not the purpose of the automatic stay to frustrate nonbankruptcy setoff rights by preventing internal creditor communications. See *In re Farmers Markets, Inc.*, 792 F.2d 1400, 1404 (9th Cir. 1986).

refusal to honor a debtor's demand for payment is "tantamount to the exercise of a right of setoff" (Pet. App. 9)—would directly nullify the complex statutory framework that protects and preserves the right of setoff. In particular, it would nullify the express statement in Section 542(b) that the creditor may refuse to "pay" a debt that is subject to setoff. By failing to recognize that the Bankruptcy Code protects the ultimate implementation of the creditor's right of setoff, the court of appeals erred in holding that a temporary refusal to pay is barred by Section 362(a)(7).

4. a. A creditor's temporary refusal to pay the claim of the debtor's estate also would not violate other aspects of the automatic stay. In *In re Patterson*, 967 F.2d at 511, the court of appeals concluded that a temporary "freeze" on the debtors' account with a credit union would violate Section 362(a)(3) of the Bankruptcy Code. That Section stays "any act * * * to exercise control over property of the estate." 11 U.S.C. 362(a)(3).[12] The court reasoned that a

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[12] In *Patterson*, the court of appeals found it unnecessary to determine whether the refusal of a bank to pay an account claimed by the debtor would represent an exercise of a "setoff" in violation of Section 362(a)(7). The court stated that, even if "we assume that a freeze is not a setoff" (967 F.2d at 509), the credit union's freeze on the debtors' account represented an "exercise [of] control over property of the estate" within the scope of the automatic stay under Section 362(a)(3). 967 F.2d at 511-512.

The court further stated, however, that, "[a]lthough we do not address here the issue of whether a freeze constitutes a setoff, per se, our opinion eviscerates the logic of those opinions which answer this question in the negative." 967 F.2d at 513. In making this assertion, the court was referring to the portion of its opinion that stated, without citation

"freeze" of the debtors' account by the credit union represented an "exercise [of] control over property of the estate" because "[t]he funds in the [debtors'] accounts became property of the estate when the [debtors] filed for bankruptcy." 967 F.2d at 511.

The analysis of the court of appeals in *Patterson* is fundamentally flawed. As this Court has noted on several occasions, a bank does not hold a discrete set of funds that belong to the depositor; instead, the bank owes its depositor a contract debt. *Barnhill* v. *Johnson*, 112 S. Ct. 1386, 1389 (1992); *Bank of Marin* v. *England*, 385 U.S. at 101. When the depositor files for bankruptcy relief, it is his contract claim against the bank—not any specified fund or set of dollar bills—that becomes property of the estate.

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of authority, that a creditor entitled to a setoff should protect its rights not by freezing the debtor's account but by filing "an ex parte motion" for relief from the stay and "accompany this motion with the funds from the debtor's account to be paid into the registry of the bankruptcy court." *Id.* at 511. In recommending that course of action, the court of appeals gave no consideration to the common meaning of the term "setoff" that Congress employed in Section 362(a)(7) (see pages 15-16, *supra*) or to the fact that the "turnover" procedures of Section 542 contemplate that the debtor, as well as the creditor, may place the matter at issue in the bankruptcy court (see pages 7-9, *supra*). There is little doubt that a creditor *could* follow the procedure recommended by the court in *Patterson*, and it also may be that a bankruptcy court could order temporary payment of the disputed account into the court's registry in a particular case. But there is nothing to indicate that Congress intended to require those procedures to be followed at the risk of contempt upon default. No other account debtor of the estate would be subject to contempt for refusal to pay a disputed claim of the estate.

Bank of Marin v. *England*, 385 U.S. at 101.[13] A refusal to pay sums that the estate claims are owed to it on a contract debt is not an exercise of control over "property of the estate." It is, instead, the assertion of a defense to the debtor's claim—a defense that Sections 553 and 542(b) specifically authorize. The bankruptcy estate steps into the shoes of the debtor and therefore necessarily has taken its claim to the account "subject" to that defense (*Bank of Marin* v. *England*, 385 U.S. at 101).

As the court of appeals explained in *United States* v. *Inslaw, Inc.*, 932 F.2d at 1473, it is not a violation of the automatic stay of Section 362(a)(3) "whenever someone already in possession of property * * * refuses to capitulate to a bankrupt's assertion of rights in that property." A creditor who is entitled to protect its right of setoff under Sections 542 and 553 of the Bankruptcy Code need not abandon that right to avoid a violation of the automatic stay under Section 362. *In re Corland Corp.*, 967 F.2d at 1077.[14]

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[13] Similarly, when a debtor has made an "overpayment" of federal taxes for which a refund is available under the Internal Revenue Code, the debtor is not entitled to any specific set of funds located in the Treasury. *United States* v. *Nordic Village, Inc.*, 503 U.S. 30, 38-39 (1992). The "property" of the debtor in that situation is his statutory cause of action for a refund. That statutory cause of action is itself, however, subject to a statutory right of setoff. See 26 U.S.C. 6402(a). If the bankruptcy estate were to bring a "turnover" action to collect the refund in bankruptcy court, the United States would not be required to pay the refund to the extent that it possesses a right of setoff. 11 U.S.C. 542(b).

[14] Cf. *In re Davis*, 889 F.2d 658 (5th Cir. 1989) (court is not to sanction creditor under Section 502(d) of the Bankruptcy Code for refusing to pay debt to estate pending resolu-

b. A temporary refusal to pay a debt owed to the bankruptcy estate also does not violate the automatic stay of Section 362(a)(6), which proscribes "any act to collect [a prepetition debt]." 11 U.S.C. 362 (a)(6). Temporarily preserving the status quo pending a determination of the creditor's setoff right by the bankruptcy court does not represent an unauthorized "act to collect"; if it did, the provisions of Section 542(b) that specify that a debt subject to setoff need not be paid would be nullified. See 11 U.S.C. 542(b). "For obvious reasons, * * * courts have recognized that § 362(a) cannot stay actions specifically authorized elsewhere in the bankruptcy code" (*United States* v. *Inslaw, Inc.*, 932 F.2d at 1474).

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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tion of creditor's right to setoff), cert. denied, 495 U.S. 933 (1990).

APPENDIX

1. 11 U.S.C. 362 (1988) provides in relevant part:

(a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970 (15 U.S.C. 78eee(a)(3)), operates as a stay, applicable to all entities, of—

* * * * *

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; * * *

* * * * *

(d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest; or

(2) with respect to a stay of an act against property under subsection (a) of this section, if—

(A) the debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization.

* * * * *

(h) An individual injured by any willful violation of a stay provided by this section shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages.

2. 11 U.S.C. 363 (1988) provides in relevant part:

(a) In this section, "cash collateral" means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.

(b)(1) The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate.

* * * * *

(c)(2) The trustee may not use, sell, or lease cash collateral under paragraph (1) of this subsection unless—

(A) each entity that has an interest in such cash collateral consents; or

(B) the court, after notice and a hearing, authorizes such use, sale, or lease in accordance with the provisions of this section.

* * * * *

(e) Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the

court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest.

* * * * *

3. 11 U.S.C. 506(a) provides:

An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

4. 11 U.S.C. 542(b) provides:

Except as provided in subsection (c) or (d) of this section, an entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order, shall pay such debt to, or on the order of, the trustee, except to the extent that such debt may be offset under section 553 of this title against a claim against the debtor.

5. 11 U.S.C. 553(a) provides in relevant part:

Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does

not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case * * *.

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